ROSEVALLEY FUNDS

Portfolio Report May 2021

The Rosevalley Behavioural Finance Funds

The Rosevalley Behavioural Finance Funds are high-conviction funds that take the theoretical and empirical evidence developed over the past 30 years in Behavioural Finance, and systematically build portfolios from these learnings. The portfolios are constructed on a benchmark-unaware basis, but performance is compared to the ASX-200 accumulation index.

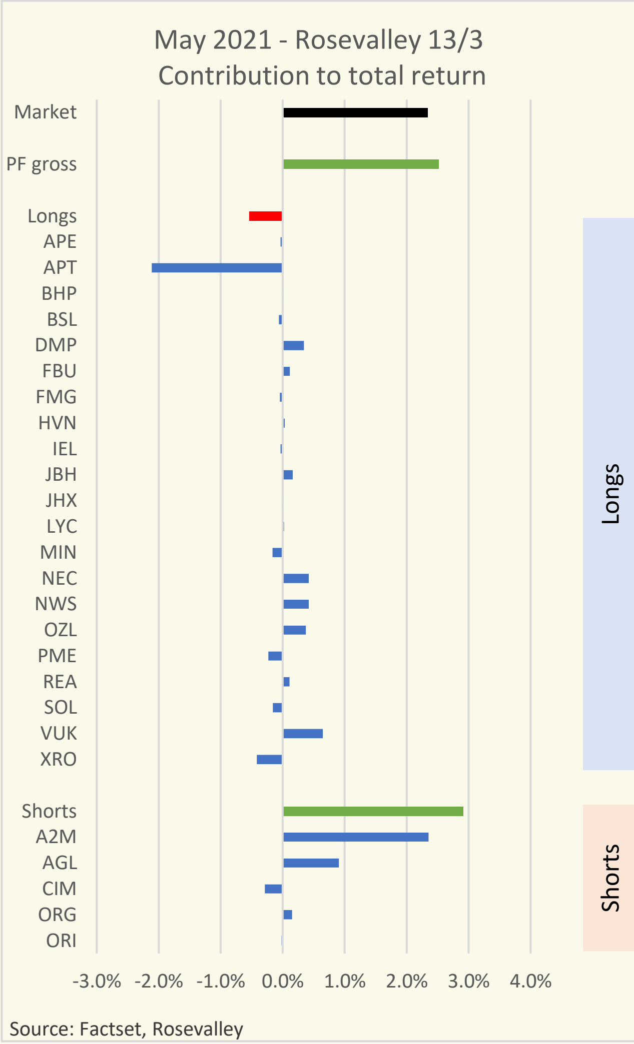
First-time readers of this report, please refer to the blue box at the end for added context and history

Market commentary

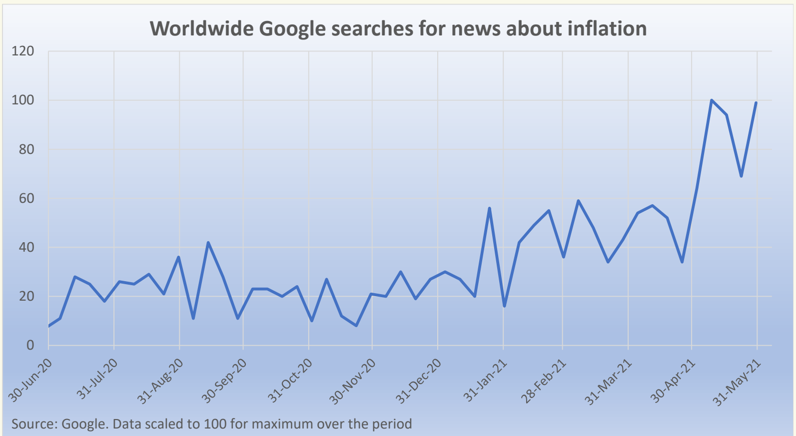
May was another positive month for global stock markets, with many reaching new all-time highs. This rise occurred against the backdrop of further inflation numbers and, perhaps more interestingly, rising confusion about what these numbers mean. Australia outperformed most global markets (and now posted its 8th consecutive positive month), and Rosevalley did better still, with Rosevalley 13/3 beating the ASX-200 by 20 bps (gross).

Total return	
	May 2021
MSCI World	0.8%
S&P 500	0.7%
DJIA	1.9%
FTSE100	1.1%
DAX	1.9%
Hang Seng	1.5%
ASX-200	2.3%
Rosevalley 13/3	2.5%

Source: Factset, Rosevalley. Note: The Rosevalley figures are unaudited.



The issue of inflation we talked about last month became even more prominent during May, and has moved from a topic of discussion among many economists and investors to one that is of interest to the population at large (see Google Trends chart on the right). The April US inflation report released in May played a large role: it showed the CPI increase for the 12 months to April was 4.2%, a stark increase on the 2.6% for the 12 months to March. At the time of writing, the May number has come out as well – at 5% another surprise for forecasters, who had pencilled in 4.7%.



Performance as of May 2021								
Portfolio		1 month	3 months	6 months	1 year	Since inception annualized (1 Oct 2018)	Since inception annualized (14 Aug 2018)	Since inception annualized (1 Aug 2018)
Rosevalley 13/3	Gross	2.5%	11.9%	19.9%	35.9%	19.5%		
	Net	2.4%	11.0%	17.5%	33.2%	16.3%		
Rosevalley 15/5	Gross	2.4%	15.0%	22.4%	35.2%		18.8%	
	Net[1]							
Rosevalley 10/0	Gross	-1.0%	4.7%	10.0%	33.7%			19.8%
	Net[2]	-1.6%	1.8%	4.3%	19.9%			6.2%
ASX-200		2.3%	8.5%	11.7%	28.2%	9.3%	8.7%	8.8%

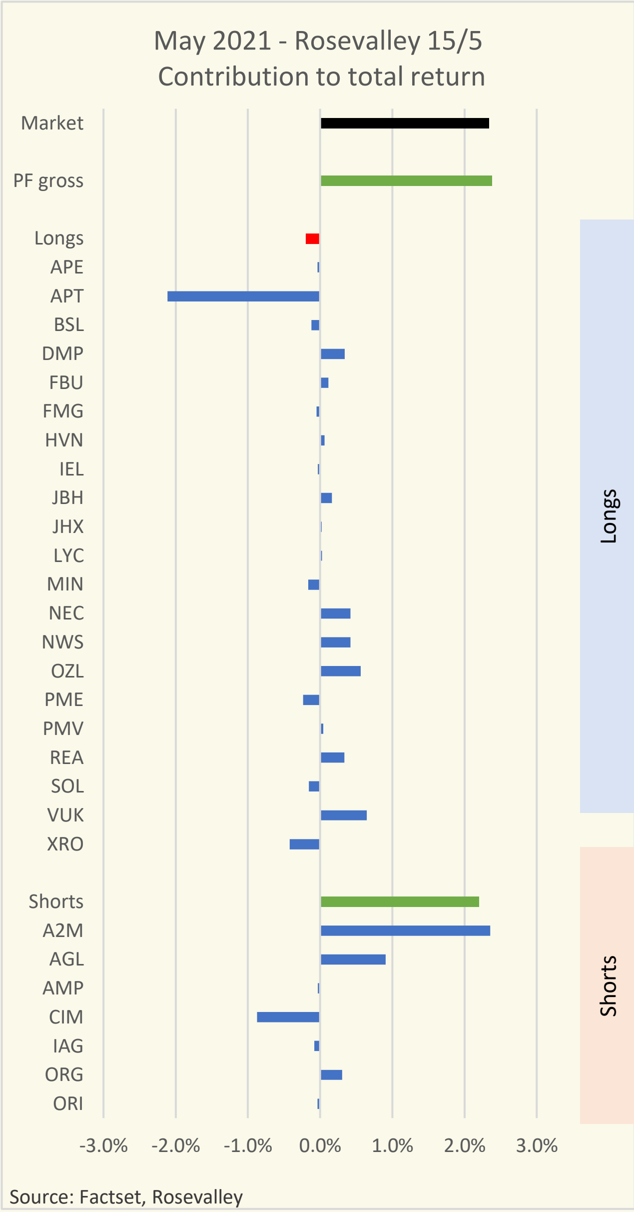
Source: Rosevalley, Factset. Note returns are not audited. [1]Rosevalley 15/5 was not actively traded during the month, so no net numbers are available. [2]Rosevalley 10/0 is traded on a demonstration basis – as a result of its small size commissions are a large proportion of assets, which explains the large gap between gross and net returns.

Many analysts, investors, economists, and leading commentators are now engaged in a debate around several (interrelated) points:

- What is causing this inflation?
- Is it transitory, or will it be sustained?
- How will Central Banks react – will they have to increase rates faster than hitherto expected?
- What does all this mean for equity markets?

Broadly speaking, there are two camps – let's call them the hawks and the doves:

- The hawks argue that the enormous fiscal and monetary stimulus of the past 18 months or so (or indeed the past 12 years) is the underlying cause of this inflation. On this view, inflation will remain high unless and until Central Banks and governments reverse their stimulatory policies. The longer they wait, the harder it is to do so, and therefore the more painful the adjustment will be. These "hawks" frequently make analogies with the 1970s, a period where the world saw "stagflation", i.e. low economic growth coupled with high inflation. On this view, equity markets are at risk: once interest rates start to rise, equity markets are likely to fall.
- The doves argue that bottlenecks in supply chains are behind the inflation numbers. As factories shut down during covid-related lockdowns, inventories dwindled. Now, as factories are reopening, they are looking to source their input materials and find that their suppliers have run down their inventories as well. Limited supply leads to higher prices. In addition, there is the base-effect: a year ago prices had actually gone down due to the collapse in demand when lockdowns were introduced. On this view there will be a period of adjustment during which prices are higher, but once everything reopens, the old equilibrium will reassert itself – thus the inflation is transitory and nothing to worry about. By extension, equity investors do not have to worry about inflation, because there is no reason to expect that interest rates will go up any time soon.



Source: Factset, Rosevalley

It's a fascinating debate from an economic point of view. While we have a view (we're probably closer to the doves than the hawks, and central banks seem to agree with us for now) we would have low confidence in our own forecast, given the unique circumstances that the world economy is finding itself in. In addition, we would argue that both sides of the debate are oversimplifying things[1].

Even if we can't meaningfully contribute to the merits of the debate, we do have some interesting things to say about how this debate is executed from a Behavioural Economics point of view. We have two observations:

- Given the huge amount of uncertainty surrounding the subject, it is quite striking to see the certainty with which both hawks and doves argue their side. This is what is called the Overconfidence Bias: the fact that people overestimate their own abilities. We can also identify the Representativeness Heuristic for those who argue similarities with the 1970s.
- As always, Confirmation Bias features in financial reporting. In this case, your story can easily change depending on what time horizon you use. Refer to the four charts at the end, which all show monthly year-on-year inflation data for the US – the only difference is how far back in time the chart goes. The first chart, for the past 12 months, looks quite alarming, as does the second one that goes back 10 years. On the 25-year chart we can see we are approaching pre-Global Financial Crisis inflation levels, a fact which has been reported widely in recent weeks. However, in the context of the last chart, which goes back 100 years, today's inflation still looks quite tame. To call a 1970s style stagflation period looking ahead certainly looks a bit premature based on this chart (the hawks' argument)!

Portfolio performance

The long/short Rosevalley portfolios were slightly ahead of the market, returning 2.4-2.5%, vs. the ASX200 at 2.3%. The long-only portfolio underperformed. All portfolios were hurt by exposure to Afterpay (APT), which declined 21% over the month – as the quintessential growth stock it was hit more than most by the inflation worries we discussed above.

Longer term performance

For the 12-month and since-inception timeframes, all Rosevalley portfolios continue to perform strongly, still an annualized ~10% ahead of market since inception.

Execution

This month the usual sources of gross-net difference worked in our favour, such that the gross-net gap was just 15 bps (vs. an expected 98 bps).

Rosevalley 13/3 Execution

	Model	Realized
Gross performance	2.52%	2.52%
deviation from model portfolio		-0.01%
difference between trade price and end-of-previous-month price	-0.67%	-0.07%
trading costs	-0.19%	-0.06%
borrow costs	-0.12%	0.00%
accrued vs paid dividends		0.00%
Reported net performance	1.54%	2.37%

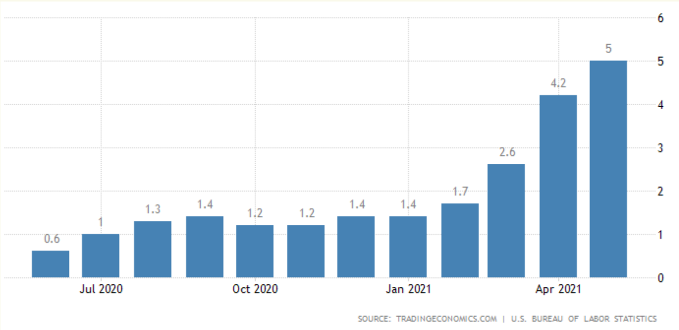
June Portfolio Manager model overrides

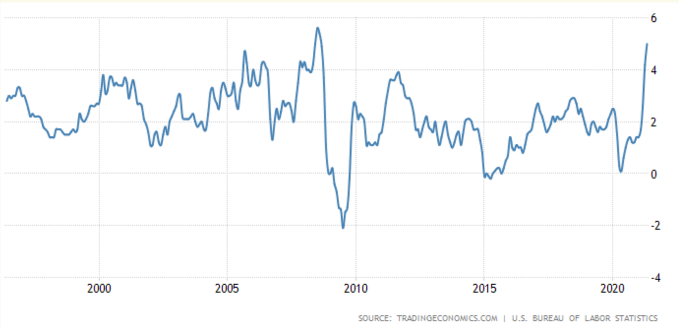
The portfolios for June have three long stock substitutions for both the 13/3 and 15/5 portfolios respectively, driven by sector concentration concerns.

	13/3	15/5
Longs taken out	LYC, BSL, FBU	LYC, BLD, FBU
Replaced by	ALQ, REA, PMV	REA, PMV, RWC
Comments	Sector concentration – in both portfolios the next stocks in the list that did not repeat the sector concentration were picked.	

[1] For instance, the long-term impact on inflation or deflation of demographics and technological advance is usually ignored.

<u>Monthly year-on-year inflation numbers for different time frames</u>





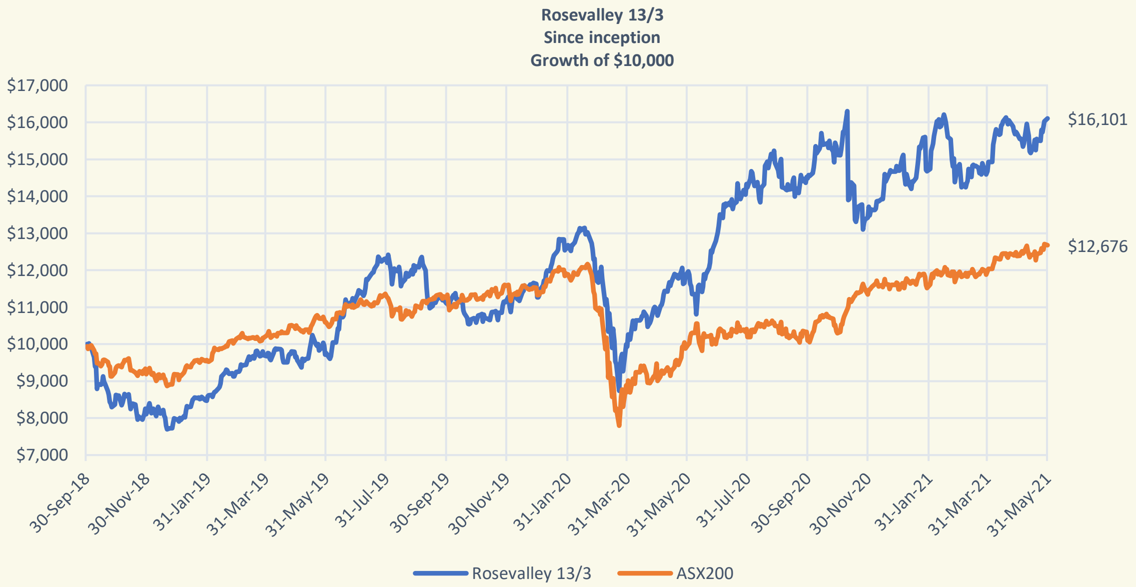
Some context for readers who are less familiar with Rosevalley Funds:

Rosevalley is a boutique funds manager with a unique approach to portfolio construction. Rosevalley Funds are constructed using the principles of Behavioural Finance (BF). Behavioural Economics and Behavioural Finance were developed over the past 30 years or so through the work of economists like Tversky, Kahnemann, Thaler, Shefrin. The idea behind BF (and the Rosevalley portfolios) is to study human behaviour as it is, not as classical economic theory says it should be (i.e. BF does not believe humans are always rationally maximizing their utility).

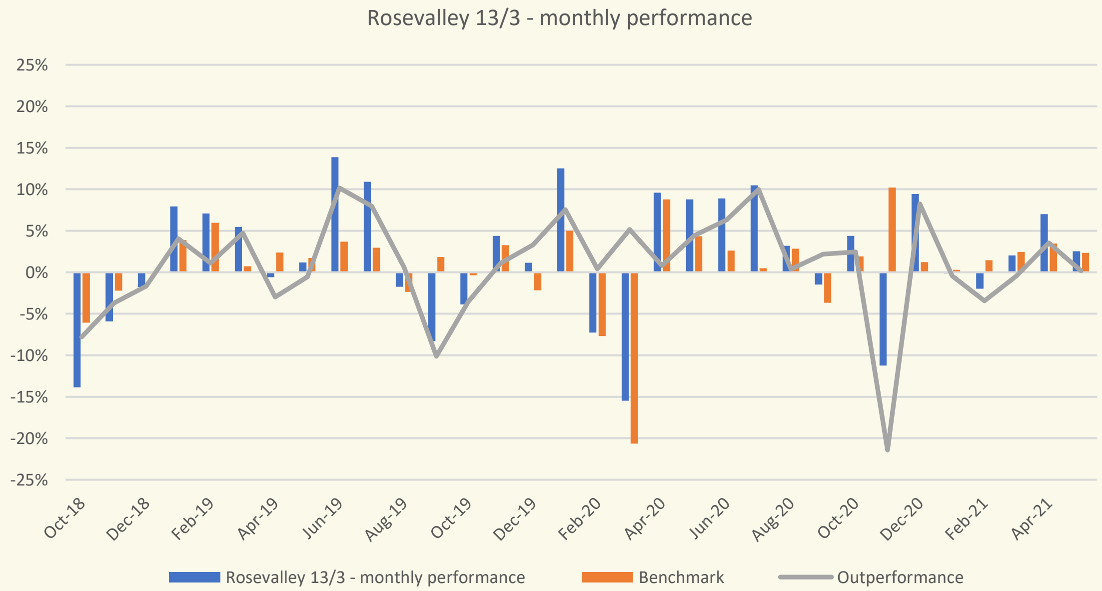
Rosevalley's portfolio construction algorithms are based on these insights. The model yields a ranking of stocks in order of greatest to smallest upside. Portfolio construction then follows by going long the stocks at the top and short the stocks at the bottom. The flagship product is Rosevalley 13/3, which is a 130/30 fund. We also run a 150/50 (Rosevalley 15/5), and a long-only fund (Rosevalley 10/0). Inception for the three portfolios was during June-September 2018.

The portfolios are rebalanced monthly. The Rosevalley team has discretion to make some substitutions, albeit that the bar for those is set high.

The monthly report discusses current events, portfolio performance, trade execution, gross-net differences, next month's portfolio, and broader market and macro expectations.



Source: Factset, Rosevalley. Note Rosevalley numbers are not audited



Source: Factset, Rosevalley

Rosevalley Funds: The Behavioural Finance Approach

Over the past 30 years Behavioural Finance has emerged as a serious alternative to the Efficient Market Hypothesis. Whereas the Efficient Market Hypothesis starts with the assumption that people (investors) are rational and profit-maximizing, Behavioural Finance builds upon empirical observations of how people actually behave, and goes on to explain securities prices from this principle. Along the development of Behavioural Finance, it has been able to explain many peculiarities that had remained puzzles under the Efficient Market Hypothesis.

Rosevalley Funds portfolios are built around the theoretical and empirical underpinnings of Behavioural Finance, and at heart take advantage of the way human beings behave in the real world.

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